Office of the
Legislative Fiscal Analyst

FY 2005 Budget Recommendations

Joint Appropriations Subcommittee for
Capital Facilities and Administrative Services

Utah Department of Administrative Services
Debt Service

Contents:

1.0 Summary: Debt Service

Debt Service is made up of interest and principal due on the State's bonded indebtedness. The State uses long term debt to finance large capital expenditures including new construction, major remodeling and highway projects. Dedicated revenue streams such as enterprise fund revenue or dedicated lease payments secure some bonds. Debt Service on Revenue Bonds and General Obligation Bonds are included in this appropriation.

Financing	Analyst FY 2005 Base	Analyst FY 2005 Changes	Analyst FY 2005 Total
General Fund	$56,833,700	$0	$56,833,700
Uniform School Fund	17,164,300		17,164,300
Centennial Highway Fund	97,724,900	29,836,600	127,561,500
Dedicated Credits Revenue	30,392,900	32,488,600	62,881,500
Beginning Nonlapsing	7,126,000		7,126,000
Closing Nonlapsing	(7,126,000)		(7,126,000)
Total	$202,115,800	$62,325,200	$264,441,000
Programs			
Debt Service	$202,115,800	$62,325,200	$264,441,000
Total	$202,115,800	$62,325,200	$264,441,000
FTE/Other			

The doubling of dedicated credits reflects a $31,590,000 payment made by the Salt Lake Organizing Committee to the University of Utah to complete payment on the Olympic housing project.

2.0 Issues: Debt Service

2.1 General Obligation Bonds (Facilities)

Debt service for FY 2005 will increase by nearly $4.9 million. Of this amount, $921,000 is to pay the final installment on a bond that had been carried in the Department of Corrections budget. The state must use General Fund for this amount, but the remaining balance may be funded from either General Fund or School Funds. **The Analyst recommends that the CFAS committee recommend to EAC funding of this item as the committee's top priority**.

State Funds (rec. for prioritization) $4,887,900

2.2 Revenue Bonds

Revenue Bonds are issued through the state Building Ownership Authority. Agencies pledge a stream of revenue (i.e., student fees or sales of product) to repay bonds. The Department of Alcoholic Beverage Control applies revenue from liquor sales to debt service on new stores, store remodeling and expansion of warehouse capacity. In some cases agencies may pledge ongoing lease funding to debt service – this type of financing is referred to as "lease revenue" financing and is not a true revenue bond. Leases should not be considered a source of revenue except by the State Building Ownership Authority. Funds expended on Revenue Bonds are considered Dedicated Credits paid to the Building Ownership Authority. Even though the cost of revenue bonds are slightly higher than general obligation bonds, they provide an extra measure of flexibility in dealing with statewide budget needs.

Dedicated Credits..$898,600

2.3 SLOC Bonds

As part of the Olympic housing project, the Salt Lake Organizing Committee (SLOC) funded dormitories on the University of Utah Campus. SLOC's payment (held in escrow) will be used to pay off the zero-coupon bond this year at a cost of $31,590,000. This appears as dedicated credits in the Debt Service budget.

Dedicated Credits...$31,590,000

2.4 General Obligation Highway Bonds

The Centennial Highway Fund provides for construction of roads and debt service on bonds. The program uses longer term bonds, but the Legislature chooses to pay those bonds on an accelerated schedule. Debt Service in FY 2005 will require an increase of Centennial Highway Fund to pay the additional $29.8 million due in the coming year.

Salt Lake County Bonds...$2,190,300

Centennial Highway Fund $27,646,300

3.0 Programs: Debt Service

3.1 FY 2005 Debt Service Needs

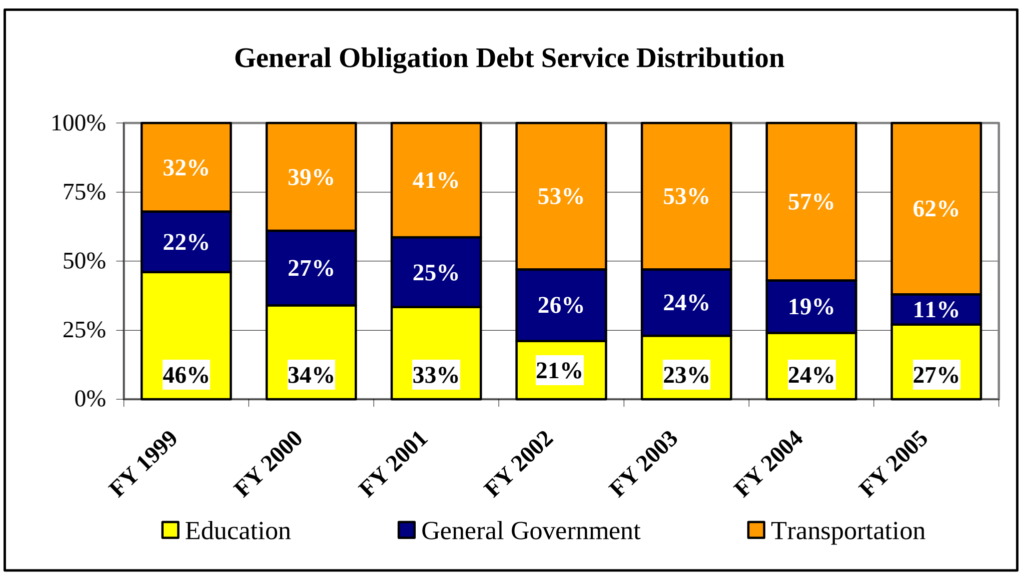
The table shown below does not include projected general obligation debt service needs for FY 2005 or an anticipated supplemental appropriation that will be required in FY 2004.

Financing	2003 Actual	2004 Estimated*	2005 Analyst	Est/Analyst Difference
General Fund	$54,833,700	$56,833,700	$56,833,700	$0
Uniform School Fund	11,466,700	17,164,300	17,164,300	
Centennial Highway Fund	84,618,200	97,724,900	127,561,500	29,836,600
Dedicated Credits Revenue	26,227,500	30,392,900	62,881,500	32,488,600
Transfers	4,997,000			
Beginning Nonlapsing	22,882,100	16,004,400	7,126,000	(8,878,400)
Closing Nonlapsing	(16,004,400)	(7,126,000)	(7,126,000)	
Total	$189,020,800	$210,994,200	$264,441,000	$53,446,800
Expenditures				
Current Expense	$189,020,800	$210,994,200	$264,441,000	$53,446,800
Total	$189,020,800	$210,994,200	$264,441,000	$53,446,800

*Non-state funds as estimated by agency

3.2 G. O. Debt Service Distribution

Over the past seven years the bulk of debt service shifted from buildings to transportation.



Source: Utah Division of Finance, GOPB and OLFA

3.3 Bonding Limitations

General obligation debt is issued and managed under the authority of the Board of Bonding Commissioners, which consists of the Governor, the Treasurer, and a member of a political party different from that of the Governor (UCA 63B-1-201).

Constitutional debt limit

The State's constitutional debt limit caps total general obligation debt at 1.5 percent of total fair market value of taxable property. For FY 2003, the Division of Finance estimates additional capacity of $965.2 million after deducting outstanding debt totaling $1.6 billion.

Constitutional Debt Limits

Constitutional Limitations (1)	**FY 2001**	**FY 2002**	**FY 2003**	**FY 2004 (2)**
Fair Market Value	$152,329,350,000	$163,185,740,000	$170,775,938,000	$170,775,938,000
Constitutional Bonding Limit	$2,284,940,000	$2,447,786,000	$2,561,639,000	$2,561,639,000
Beginning G.O. Debt	$1,212,325,000	$1,146,000,000	$1,498,371,000	$1,713,755,000
Principal Payment	($81,325,000)	($92,800,000)	($97,550,000)	($111,810,000)
Bonds Sold	$15,000,000	$421,200,000	$278,705,000	
Bond Principal Refunded		($208,000,000)	($413,675,000)	
Refunding Bonds Sold		$208,000,000	$381,800,000	
Net change in Premiums (3)		$23,971,000	$66,104,000	($5,465,000)
Outstanding Bonds, Net (3)	$1,146,000,000	$1,498,371,000	$1,713,755,000	$1,596,480,000
Additional Bonding Capacity	*$1,138,940,000*	*$949,415,000*	*$847,884,000*	*$965,159,000*

(1) For fiscal years 2001, 2002, and 2003 bonding capacity is as of June 30 of the respective fiscal year. Bonding capacity for fiscal year 2004 is as of December 31, 2003.
(2) The fair market value for FY2004, which is the 2003 calendar year end fair market value is unavailable at this time, so the calendar year 2002 fair market value has been used.
(3) Beginning in Fiscal Year 2002, the State was required to include premiums and deferred amount on refunding, when calculating the debt limits
Source: Utah Division of Finance

Statutory debt limit

The State Appropriations and Tax Limitation Act (UCA 63-38c-402) further limits general obligation debt to 20 percent of the allowable spending limit from the General Fund, Uniform School Fund, and Transportation Fund, less debt service. The limitation is established using a formula that includes population growth, inflation, and 1985 appropriations as a baseline.

For FY 2004, the statutory general obligation debt limit is $856.4 million. $984 million of transportation bonds are exempted from the statutory limitation, leaving $612.4 million to apply to the limit. Combined with $28.6 million of unissued (but authorized) bonds, the State has approximately $215.4 million in additional bonding capacity.

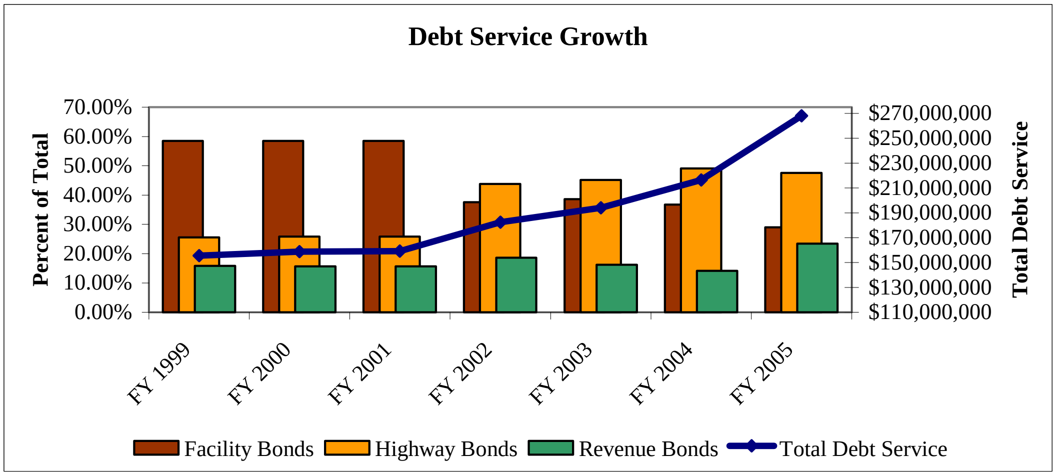
Statutory Debt Limits

Statutory Limitations (1)	**FY 2001**	**FY 2002**	**FY 2003**	**FY 2004 (2)**
Appropriations Limitation	$3,798,512,000	$4,176,703,000	$4,150,684,000	$4,282,086,000
Statutory Bonding Limit	$759,702,000	$835,341,000	$830,137,000	$856,417,000
Outstanding Bonds, Net (3)	$1,146,000,000	$1,498,371,000	$1,713,755,000	$1,596,480,000
Exempt Transportation Bonds, Net (3)	($908,000,000)	($1,004,004,000)	($1,020,049,000)	($984,063,000)
Non-Exempt Bonds, Net (3)	$238,000,000	$494,367,000	$693,706,000	$612,417,000
Additional Bonding Capacity	*$521,702,000*	*$340,974,000*	*$136,431,000*	*$244,000,000*

(1) For fiscal years 2001, 2002, and 2003, bonding capacity is as of June 30 of the respective fiscal year. Bonding capacity for fiscal year 2004 is as of December 31, 2003.
(2) Capacity does not include approximately $61 million of debt authorized but not issued.
(3) Beginning in Fiscal Year 2002, the State was required to include premiums and deferred amount on refunding, when calculating the debt limits
Source: Utah Division of Finance

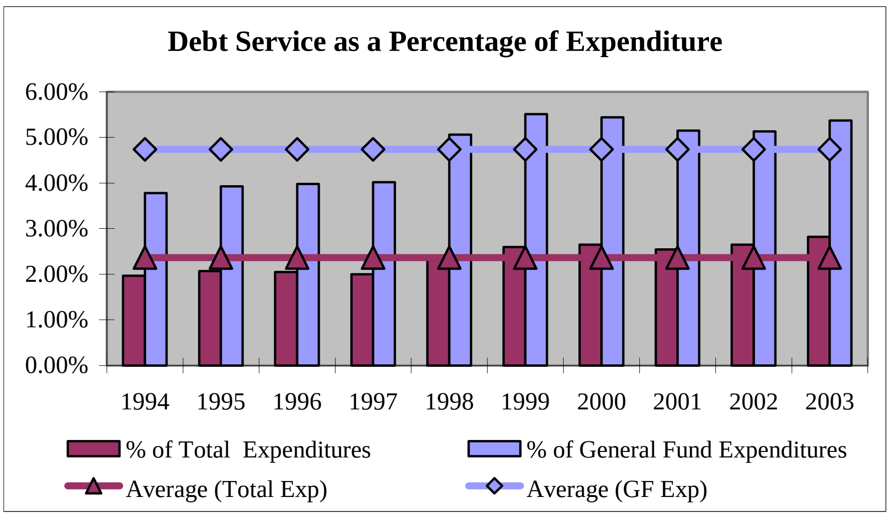
3.4 Growth in Debt Service

The Legislature uses several tools to finance new facilities. Bonds issued for facility construction are amortized over a six year period. The state pays interest for five years, then a lump sum principal payment in the final year. For a variety of reasons (i.e., structural delays from the legislative process, construction delays, procurement extensions) bonds issued by the state are actually amortized for less than six years – it is more realistic to assume that bonds will actually be issued and amortized over a period of 54 to 60 months.



Source: GOPB and OLFA

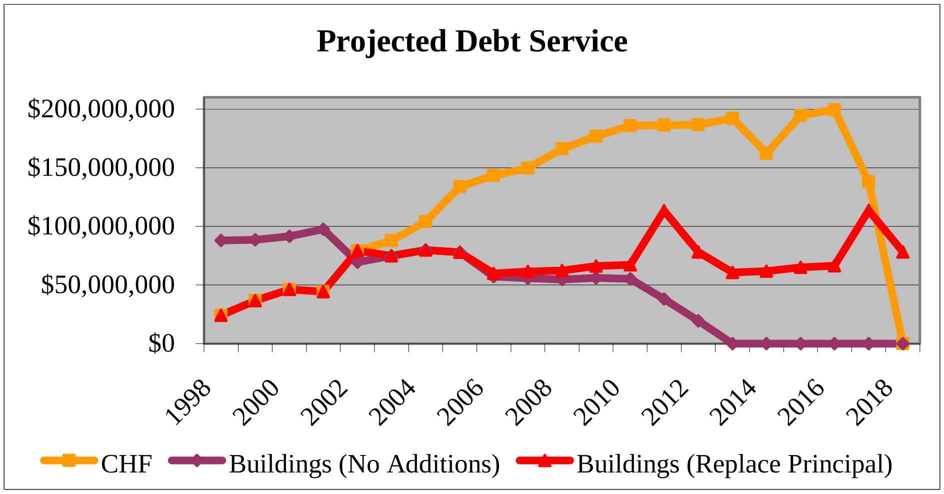
One advantage of bonding is that the borrower pays back present value with future dollars. Long term bonds may offer value in excess of present value, but if a state issues long term bonds every year it may ultimately find that debt service will become a driving force for all budget decisions. Utah has long been known as a very conservative state when it comes to bonding – but debt service is projected to exceed five percent of General Fund expenditures in FY 2005.



Source: Utah Division of Finance CAFR and OLFA

PAYGo provides long term flexibility

Utah's debt service is driven by the issuance of a significant amount of highway bonds. These bonds are amortized for a longer period than facility bonds and the Legislature chooses to pay them back at an accelerated rate. Current projections show annual transportation debt service increasing to over $190 million before the Centennial Highway Fund is fully paid off.



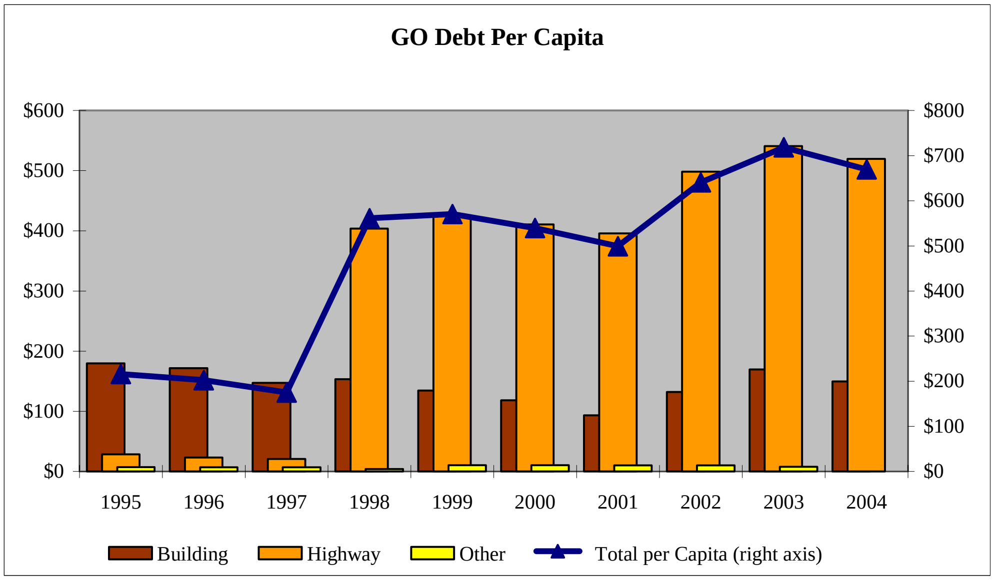
Source: Office of the Legislative Fiscal Analyst and GOPB

When bonds are issued annually, at some point a significant amount of money is being spent for interest rather than construction. This is a dual drain on resources. Although cash funding for capital projects carries some opportunity cost, the Analyst believes that it is better to put money into job-creating construction rather than interest payments. Clearly, this can not be done all the time – unique and significant projects such as the I-15 reconstruction project or the restoration of the State Capitol are projects that would be difficult to fund with cash.

Last year, with cash appropriations limited to AR&I funding, the Legislature committed to funding new facility bond levels at the amount of principal retired in the fiscal year. Such a plan keeps debt service under control, but makes it difficult for the state to move to a "pay as you go" (PAYGo) system. The Legislature initiated a PAYGo plan in 2000 that became a source of funding for state government during the downturn. The Capital Budget provided a sort of secondary rainy-day fund that relieved $233 million to the FY 2002-2003 shortfall. The Analyst believes that this was wise budgeting on the part of the Legislature and recommends that future sources of one-time funds be applied to capital projects to re-start the PAYGo plan.

Per Capita Debt tripled in ten years

Growth creates a huge impact on state governments, so any analysis of budget increases should be matched against population growth. Utah's growth is primarily internal, meaning that the state must contend not only with the problems of a growing population, but also the problems brought by a young population that can not contribute to the tax base. Even when twenty percent growth is considered, Utah now finds itself in unprecedented territory in relation to outstanding debt. Due to the I-15 project, debt is now three times higher per capita than it was ten years ago, reaching $700 per Utahn.



Source: Utah Division of Finance CAFR and OLFA

Utah is one of seven states with a "Triple AAA" Bond Rating

National rating agencies such as Moody's, Fitch or Standard and Poor's provide ratings of the credit-worthiness of all states. At this time only seven states merit a AAA rating from all three agencies. During the budget downturn of FY 2002-2003 several states received downgrades to their rating. Downgrades came as a result of failure to address deficits[1], failure to match ongoing expenditures ongoing revenue,[2] significant reductions in fund balances and reserves[3] or industrial uncertainty.[4] In assessing ratings, agencies look to a state's economy, flexibility in finances, debt burden and management.

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[1] Tennessee (http://www.tennessean.com/local/archives/01/04/07415882.shtml)
[2] North Carolina (http://www.ncgop.org/news/Moodys_Downgrades_NC_Bonds-081902.html). It should be noted that North Carolina is now back to AAA status.
[3] Indiana (See Jan. 21, 2004 issue of *The Bond Buyer,* p. 25). Washington state (See Jan. 30, 2004 issue of *The Bond Buyer,* p. 1).
[4] Michigan (http://www.detnews.com/2003/politics/0311/19/b09e-329144.htm)

Utah maintains a AAA rating in large part because of the commitment to good management shown by both the Executive and Legislative Branches. Utah's stable economy with a young and growing population provides a ready source of labor and a growing tax base. Utah also maintains a diverse revenue collection system and takes the issue of structural balance (matching ongoing revenue to ongoing expenses) seriously. While debt levels are at all time highs the debt is tied to fixed assets rather than operating costs. Repayment plans are aggressive and workable – rating agencies believe that Utah can and will maintain its ability to pay.

Inter-branch cooperation and management provide are among the strongest factors in Utah's "Triple AAA" rating is. In the Executive Branch the Division of Finance follows GAAP and GASB accounting practices. The timely publication of the Comprehensive Annual Financial Report (CAFR) assures rating agencies that oversight systems are in place. In the Legislative Branch the commitment to limited indebtedness, restoration of aging facilities (AR&I) and the ability to present a balanced budget on time are key factors to planning.

Rating agencies seem to focus more on planning than anything else. They do not expect rainy day funds to be restored overnight, but they expect states to have a workable plan to prepare for the next down turn. Agencies want to see development plans such as the Five Year Book for buildings or the Centennial Highway Plan for roads. Ratings are based on a state's ability to manage. So long as the state's tax base is solid, it's economy sound, and state managers (both elected officials and professional staff) are committed to fiscal discipline then Utah will maintain a AAA rating.

Planning and Management are keys to AAA Rating

Although no single policy or decision (within the realm of reason) will change the strength of Utah's rating, the Analyst does note that several bond-rating factors should be considered in preparing the FY 2005 budget.

Structural Balance: In a report presented to Executive Appropriations Committee in July the Analyst noted the state could balance

> ongoing appropriations with ongoing revenue at the close of each appropriations session. Such balancing could be accomplished by providing one-time rather than ongoing appropriations for discrete projects such as capital investment, all the while analyzing the impact of such action on long-term needs. [5]

Planning: The state's Five Year Building Plan and Centennial Highway Plan are examples of taking a long term view of future needs. The Legislature must also maintain a plan for debt service – any funding plan that omits a reasonable plan for repayment of debt obligations is likely to be viewed negatively by rating agencies. Continued commitment to restoring the rainy day fund over time will also strengthen the state's credit rating.

[5] Ball, Jonathon, et al. (2003). Balancing the Structural Deficit. Salt Lake City, Utah: Office of the Legislative Fiscal Analyst. http://www.le.state.ut.us/interim/2003/pdf/00000866.pdf

Balancing Growth vs. **Infrastructure**: Utah will spend more than $40 million in FY 2004 and again in 2005 to repair and upgrade state facilities. Over the past five years the Legislature also devoted funds to replacing large facilities that no longer were safe or able to function properly. This focus on preventing an infrastructure crisis is a positive with rating agencies, but that does not obviate the need to provide facilities for a growing system of higher education. As the state's population grows, the need for more space on college campuses will add pressure to the state's budget.

3.5 Capital Facility Financing

The State employs several methods of financing to meet state needs.

General Obligation Bonds - G.O. debt is secured by the full faith and credit of the State and its ability to tax its citizens. General Obligation debt is counted against the state's constitutional and statutory debt limits (certain highway bonds are exempt from the statutory limit). In recent years the State of Utah issued General Obligation Bonds for facilities that mature in six years. Other states and government entities typically issue General Obligation Bonds with terms of 10 to 20 years. Debt service interest begins to accrue when the bonds are issued.

Revenue Bonds - The State Building Ownership Authority, the official owner of state facilities, issues Revenue Bonds. This type of bond may be issued when a revenue stream can be identified and legally restricted for repayment of the bonds. The only state facilities which have been financed using Revenue Bonds have been for higher education facilities where the revenues pledged have included student fees, auxiliary services revenues, or reimbursed overhead. In order for the bonds to be marketable, the pledged revenue stream must be substantially larger than the debt service requirements. This type of debt is not secured by the full faith and credit of the state nor its taxing power and is exempted from calculations of the state's constitutional and statutory debt limits.

Lease Revenue Bonds - The occupying agency pays rent to the Authority which is used to pay debt service. A pledge of future rental payments (subject to legislative appropriation) and a mortgage on the financed project secure debt.

Since neither the full faith and credit of the state nor its taxing power secure lease Revenue Bonds, they are not counted against debt limits. However, subsection 63b-1-306 states the debt issued by the Building Ownership Authority plus other debt issued by the State (less $984 million in highway debt) cannot exceed 1.5 percent of the value of the taxable property of the state. A statutory change would be required for BOA bonds if G.O. bonds were authorized up to the constitutional limit. Unlike General Obligation Bonds, Revenue Bonds are typically issued with a repayment period of 20 years. An additional amount is borrowed to cover interest payments during construction.

Certificates of Participation (COP) - COP are very similar to lease Revenue Bonds with one major difference: instead of being a bond issued directly by a governmental entity, COP's represent an undivided interest in a lease agreement. This lease agreement may be entered into by any entity that has the ability to lease space. Although either the state or a private entity may initially hold title to the facility, title must pass to the state by the end of the lease term in order for the interest on the COP to be exempt from federal income tax.

Summary - All of the above are accounted for as debt on the state's accounting records and are considered to be debt by national rating agencies. In addition, the State Auditor issued an opinion in December of 1995 that any General Fund, Uniform School Fund, or Transportation Fund used to retire lease purchase and revenue bond obligations should be counted in the spending limitation formula.

Relative Costs

The total cost associated with various options for financing projects are listed below, ranked from least expensive to most expensive. Specific projects may have circumstances that would affect this ranking. The order for Revenue Bonds and certificates of participation depends on the nature of the project and the source of funding for the debt service.

1. Cash (state funds)
2. General Obligation Bonds
3. Lease Revenue Bonds
4. Revenue Bonds
5. Certificates of Participation
6. Leasing (long-term)

The true cost of bond financing may be much less than commonly assumed because most of the state's payments to investors are made in future years using dollars that may be cheaper due to inflation. However, savings from inflated dollars are difficult to achieve with short-term bonds. The Analyst believes that the differential in interest costs and inflation savings should be considered when the state issues general obligation debt.

The relative cost of different types and terms of debt fluctuates with the financial market. As a general rule, a 20 year general obligation bond carries an interest cost which is about two thirds of one percentage point higher than a 6 year General Obligation Bond. A twenty year lease revenue bond carries an interest cost which is about one third of one percentage point higher than a 20 year general obligation bond. Interest rates for certificates of participation are generally higher than lease Revenue Bonds. By far the largest costs occurs when the state enters into a long term lease instead of purchasing a building that an agency will need for fifteen or twenty years.

Suggested Policy Issues

During the 1996 General Session, the Legislature adopted general guidelines for issuance of state debt. The Analyst recommends the adoption of those guidelines again for the 2004 General Session.

General Obligation bonding should be the preferred method for critical facilities whose costs exceed the availability of current funding. It is assumed that the need for the facility has received full analysis for justification. Short term bonds (6 to 10 years) should be used when a facility has no present funding base to service debt and when the building fulfills a critical need that can not be funded within the base budget for capital facilities. Long term bonds should be used (15 to 20 years) when there are current facility occupancy costs within the agency base budget that could be used to assist the funding of debt service.

Current market conditions should also be considered when bonding is discussed. For example, if current rates are lower than what the Treasurer is earning on the state investment pool, it may be a favorable time to bond. This is especially true with short term bonds that will not recover interest costs through inflation.

Revenue Bonds should be considered when a dedicated source of revenue is available to cover underwriting requirements. Generally, a coverage ratio is required that is in excess of actual debt service. Examples would include higher education facilities such as dormitories and parking lots where the funding source for debt service is derived from rents or fees.

Lease Revenue Bonds or *Certificates of Participation* should be used if the Legislature is willing to fund a lease for a long term facility. This type of funding could be considered when an agency has an outside source of revenue in addition to any existing costs in the budget base. An example would be the State Library where Federal funds are available as lease costs but federal regulation may not allow the funds to be used for debt retirement. Of course, it would be wiser still to issue a long-term General Obligation bond instead and shift the operating funds to debt service. Caution should be exercised by the Legislature to avoid excessive lease purchase obligations since they are treated like debt once funds have been committed. If funds were not appropriated in a given year the state would enter into a default position. Lease Revenue Bonds should be issued with a repayment period not to exceed 20 years.

Leasing provides the least expensive option for space only for short term needs. Some programs are temporary in nature or provide a function that needs to be able to change locations frequently. The Analyst recommends that DFCM continue to provide funding alternatives for the Legislature when agency high cost leases are requested. High cost leases are defined in statute as real property leases that have an initial term of ten years or more or will require lease payments of more than $1,000,000 over the term of the lease, including any renewal options.

4.0 Tables: Board of Bonding Commissioners - Debt Service

Financing	2001 Actual	2002 Actual	2003 Actual	2004 Estimated*	2005 Analyst
General Fund	$73,223,900	$38,084,800	$54,833,700	$56,833,700	$56,833,700
Uniform School Fund	20,152,500	24,670,600	11,466,700	17,164,300	17,164,300
Centennial Highway Fund	41,104,400	82,657,500	84,618,200	97,724,900	127,561,500
Centennial Highway Fund, One-time	3,079,000				
Dedicated Credits Revenue	20,044,000	33,909,700	26,227,500	30,392,900	62,881,500
Transfers	3,999,800	6,638,700	4,997,000		
Beginning Nonlapsing	8,757,200	12,109,400	22,882,100	16,004,400	7,126,000
Closing Nonlapsing	(11,474,700)	(22,882,100)	(16,004,400)	(7,126,000)	(7,126,000)
Total	$158,886,100	$175,188,600	$189,020,800	$210,994,200	$264,441,000
Programs					
Debt Service	$158,886,100	$175,188,600	$189,020,800	$210,994,200	$264,441,000
Total	$158,886,100	$175,188,600	$189,020,800	$210,994,200	$264,441,000
Expenditures					
Current Expense	$158,886,100	$175,188,600	$189,020,800	$210,994,200	$264,441,000
Total	$158,886,100	$175,188,600	$189,020,800	$210,994,200	$264,441,000
FTE/Other					

*Non-state funds as estimated by agency.